STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	)	
	)	**Docket No. 12-0511**
Proposed General Rate Increase for Gas Distribution Rates	)	
	)	
	)	
Peoples Gas Light and Coke Company	)	
	)	**Docket No. 12-0512 (cons.)**
Proposed General Rate Increase for Gas Distribution Rates	)	

REPLY BRIEF ON EXCEPTIONS OF

THE PEOPLE OF THE STATE OF ILLINOIS

The People of the State of Illinois

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NOW COME the People of the State of Illinois ("the People"), by Lisa Madigan, Attorney General of the State of Illinois, and pursuant to Part 200.830 of the Illinois Commerce Commission's ("the Commission") rules, 83 Ill.Admin.Code Part 200.830, hereby reply to the Brief on Exceptions and Exceptions filed by the Peoples Gas Light & Coke Company ("Peoples" or "PGL") and North Shore Gas Company ("North Shore" or "NS") (collectively "the Companies").

I. INTRODUCTION

The Companies' Brief on Exceptions repeats the same theme the Companies presented throughout the case: unless they receive an Order that recovers every penny of their inflated revenue requirement request, they will be unable to recover their costs, including costs projected to be spent for the PGL Accelerated Main Replacement Project ("AMRP"). But as noted throughout the AG briefs filed in this case, the Commission's analysis must begin with the recognition that the Companies' proposed revenue requirements are based on an inflated,

forecasted future test year. Claims that costs will not be recovered are really complaints that the adjusted test year revenue requirements are inconsistent with the Companies' flawed projections.

In addition, the Companies continue to claim that they need more cost recovery through the fixed customer charge portion of residential bills, despite compelling evidence that a significant portion of the Companies' costs are in impacted by customer usage, thereby supporting the People's recommendations that the Companies' customer charges for the residential heating class not be increased as both the Companies, and to a less extent, Staff, suggest.

The People urge the Commission to reject the Companies' complaints voiced in their Brief on Exceptions, and enter a final order consistent with the AG Brief on Exceptions and this Reply Brief on Exceptions.

II. RATE BASE

A. Year-End or Average Rate Base

In their criticism of the Proposed Order's correct adoption of incorporating an average rate base, rather than the inflated year-end or so-called "compromise" year-end hybrid proposal offered by the Companies, NS/PGL complain that the Proposed Order's conclusion has "a huge impact on rate base, including AMRP costs." NS/PGL BOE at 13. They note that the average rate base method reduces Peoples Gas' proposed rate base by $95,688,000 and its annual revenues (cost recovery) by $9,854,000 and North Shore's rate base by $6,508,000 and its annual revenues by $658,000. *Id.*

These facts, however, only highlight how inflated the Companies' forecasted year-end rate base and, correspondingly, customer rates would be if the Commission adopted either of the Companies' illogical and ultimately unlawful rate base calculation proposals. It is, first, critical

to remind the Commission as it contemplates the Companies' exceptions that the rates in this case are being set based on a *future* test year. In this case, that year is 2013. Rates for this case will be set by early June, 2013, when the statutory 11-month review period ends[1]. The Companies' proposed rate base is forecasted at ***year-end*** as of December 31, 2013, while the balance of the test year revenue requirement calculations, including revenues, O&M expenses and cost of debt, utilizes forecasted ***average*** data expected to be experienced throughout calendar year 2013. AG Ex. 1.0 at 6. So when the Companies claim that the average rate base adjustment has a huge impact on plant investment cost recovery and the Accelerated Main Replacement ("AMRP") costs included in rates , that admonition should be tempered with the knowledge that the average rate base adjustment (1) simply reduces the amount incorporated in the *forecasted* test year revenue requirement *to match the average calculation of operating expenses, revenues and cost of debt* also incorporated in the test year revenue requirement*;* and (2) in no way constitutes some kind of disallowance of invested plant costs, as the Companies' protestations might suggest. As discussed further below, the Companies' arguments in support of a year-end rate base, or its alternative September 2013 rate base calculation, should be rejected.

1. Test Year Matching Principles Require the Use of An Average Rate Base in This Case.

The Companies hybrid test year approach -- using average forecasted operating revenues and operations and maintenance ("O&M") expenses throughout the 2013 test year that have not been annualized at year-end, while proposing a year-end rate base including net plant investment that is forecasted to exist at year-end – results in a mismatch of rate base and operating income elements, which under test year regulation, are matched and made to be internally consistent. The result of the Companies' proposals, including the purported

[1] *See* Section 9-201(b) of the Public Utilities Act, which provides an 11-month period for the review of proposed rate changes. 220 ILCS 5/9-201(b).

"compromise" proposal, which would incorporate forecasted plant values from September of 2013, result in a mismatch of the revenue requirement elements used to set rates and would result in ratepayers paying rates that fail to reflect the Companies' actual capital costs.

Both AG witnessess Brosch and David Effron, as well as Staff witness Daniel Kahle and CUB witness Ralph Smith, recommended that an average rate base be employed in setting the Companies' rates, so as to match the average income statement and cost of capital calculations that are employed, while not overstating the revenue requirement expected to be incurred in the 2013 test year. The Companies claim in their Exceptions, however, that use of an average rate base will yield revenues that do not match the Companies' costs. NS/PGL BOE at 14-16. The Companies include charts, too, which purport to suggest that the Companies' compromise September, 2013 rate base calculation proposal would better match projected gross plant investment for the 2013 period. *Id.* These graphics, however, in no way support Commission modification of the Proposed Order's conclusion on this issue.

First, the data in the charts highlighted by the Companies at pages 14 and 15 of their BOE show projected *gross* plant investments for 2013. Data detailing projected *gross* plant investment is meaningless in isolation. That is the case because rates are not set solely based upon changes in gross plant. The rate base properly matches growth in gross plant along with an offset for the continuous and offsetting growth in accumulated depreciation and accumulated deferred income taxes. Thus, when the Companies claim that an average rate base calculation would not permit them to recover their "costs" or that the end-of-year or compromise method of calculating rate base would better reflect their rate base investment for the 2013 test year, their claim starts from a inaccurate premise: that forecasted 2013 gross plant somehow represents their actual net investment levels incurred to provide service to ratepayers.

Moreover, these claims in their BOE ask the Commission to violate its own test year rules by attempting to isolate rate base dollars and accounting for them on an end-of-year basis, while measuring and calculating O&M expenses, revenues and the Companies cost of debt based on an average test year methodology. For example, during cross examination, NS/PGL witness James Schott confirmed that the Companies rate case presentation does not provide for year-end plant depreciation levels, AMRP contract amounts or bad debt expense, to name a few operating income items. Tr. at 402-406. Instead, these revenue requirement elements are calculated based on an averaging of the test year amounts throughout the year.

In order to accurately determine the utility's revenue requirement, the Commission established filing requirements under which a utility must present its rate case supporting data in accordance with a proposed one-year test period. Section 287.20 of the Commission's rules provides that a utility may, at its option, propose either an historical or a future test year. 83 Ill.Admin.Code Part 287.20. The purpose of the test-year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year. *Business & Professional People for the Public Interest v. Illinois Commerce Commission,* 136 Ill.2d 192, 219 (1989) ("*BPI I")*.

In interpreting the Commission's test year rules, Illinois courts have emphasized that the purpose of test year ratemaking is to evaluate and measure the cost of service and resulting revenue requirement through a balanced review of jurisdictional expenses, rate base investment, the cost of capital and revenues undertaken at a common point in time. *See Business & Professional People for the Public Interest v. Illinois Commerce Commission,* 146 Ill.2d 175, 238, 585 N.E.2d 1032 (1991). While court rulings have typically focused on claims for recovery of expenses, plant or other elements outside of a test year, the reasoning that emphasizes the

balanced review of revenue requirement elements can be applied to the end-of-year vs. average rate base issue. The point is that measuring one revenue requirement element – in this case, rate base – at one point in time within the test year, and other elements – including revenues, expenses and the cost of debt – on an average basis, creates a mismatch not contemplated in the test year ratemaking process. While not *specifically* prohibited in the language of the Commission's test year rules, the mismatched rate base calculation proposed by the Companies in this case is inconsistent with the matching principle that is the foundaton of test year ratemaking.

Next, the Utilities argue that the adoption of an average rate base calculation for purposes of setting rates would "better match the Utilities' cost of service during the period in which the rates will be in effect", and claim that the Proposed Order disregarded or placed no value on that argument. But rejection of the argument was correct both factually and as a matter of law. It is not the job of the Commission to look beyond the test year or imagine how long rates might be in effect for purposes of establishing rate base numbers. In fact, the Commission has never adopted a policy that rates set in a rate case must "match the costs of service in the period in which they will be in effect." As noted above, this is an impractical and impossible notion because new utility rates are routinely established for application indefinitely into the future, for all months after the effective date until a next rate case is filed and completed, based on a newer test year.

Moreover, all of the elements of the revenue requirement are subject to change and can be expected to change between rate case orders. Accordingly, it is impossible to accurately predict how the timing of when new rates becoming effective will impact a utility's earnings. AG Ex. 1.0 at 11. If future revenue or cost variances from the test year 2013 amounts that are used to set rates are favorable, the Company's earnings are likely to exceed authorized levels.

Conversely, if such financial variances are negative, earned returns may be lower than authorized levels.

2. No "Changed Circumstances" Exist That Justify Deviating From the Commission's Traditional Use of An Average Rate Base in Future Test Year Rate Cases.

The Utilities additionally argue that past Commission decisions are not *res judicata* and that the "changed circumstances" of the instant docket support adoption of either an end-of -year rate base or the September calculation. NS/PGL BOE at 17. The changed circumstances, according to the Companies, are "the timing of when the rates being set will go into effect and the loss of their infrastructure cost recovery rider due to an appellate decision." *Id.* This argument should likewise be rejected. While the People agree, of course, that Commission decisions are not *res judicata*[2], decisions that drastically depart from past practice are entitled to less deference. *BPI I,* 136 Ill.2d at 228. If the Commission adopted the Companies' argument on the calcuation of rate base in a future test year, that decision would constitute a drastic departure from past practice. Mr. Effron testified that it has been the consistent practice to use an average rate base when a future test year has been used to determine a regulated utility company's revenue requirements. For example, in each of the Companies' two most recent rate cases, (Docket Nos. 09-0166 and 11-0280 for North Shore and Docket Nos. 09-0167 and 11-0281 for PGL) a future test year was used to determine the revenue requirements, and in all cases, the future test year rate base was an average rate base. The same is true for the most recent cases filed by Ameren Illinois Company (Docket Nos. 11-0279 and 11-0282), and Nicor Gas Company (Docket No. 08-0363).[3]

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[2] *See Mississippi River Fuel Co. v. Illinois Commerce Comm'n,* 1 Ill.2d 509, 513 (1953),

[3] In his direct testimony, Staff Witness Kahle noted that in Docket No. 04-0779, Northern Illinois Gas Company ("Nicor") proposed a future test year with a year-end rate base, but that the Commission rejected this approach, finding that an average rate base "better matches the level of rate base during the test year with the

As for the timing of when rates will be in effect, the Companies chose the calendar year 2013 as their test year. Had they hoped to reflect higher and more distant Plant investment levels in forecasted revenue requirement elements, they could have chosen a different 12-month period. Under Part 287.20 of the Commission's rules, the Companies can select a future test year consisting of "[a]ny consecutive 12 month period of forecasted data beginning no earlier than the date new tariffs are filed and ending no later than 24 months after the date new tariffs are filed." 83 Ill.Admin.Code Part 2887.20. In the instant case, the Companies could have selected a test year ending as late as July 31, 2014 (tariffs were filed on July 31, 2012). They chose to use calendar year 2013 instead. Having made that decision, it is unreasonable to then complain that the Commission's routine practice of using an average rate base to reflect future test year rate base costs is somehow unreasonable and confiscatory.

In addition, the Companies' complaint that Rider ICR being ruled unlawful by the Appellate Court created some changed circumstance that justifies the Commission altering its typical ratemaking procedures is equally specious. NS/PGL BOE at 17. Altering traditional ratemaking procedures relative to the Companies' claims that typical Commission ratemaking procedures are inadequate to permit the Companies' recovering their "costs" is what got the Commission into trouble in the Appellate Court when it approved Rider ICR in the Companies' 2011 rate case. *See People ex rel. Madigan v. Illinois Commerce Comm'n,* 2011 IL App (1st) 100654. The People urge the Commission to reject these entreaties to bend the ratemaking rules

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revenues and expenses during the test year." Staff Exhibit 2.0, at 7-8. Nicor filed that case in November 2004, with a future test year consisting of the twelve months ending December 31, 2005 and the rates set to go into effect in October 2005. In other words, in Docket No. 04-0779, the new rates did not go into effect until approximately ten months after the beginning of the future test year. Yet the Commission found that an average rate base was appropriate (while use of a year-end rate was not) in those circumstances. If the use of an average rate base was appropriate in Docket No. 04-0779, it is certainly appropriate in the present case. AG Ex. 5.0 at 2-3.

in order to accommodate these Companies efforts to maximize revenues and inflate customer rates.

The Companies' so-called alternative or compromise proposal offered by the Companies for the first time in NS/PGL witness John Hengtgen's surrebuttal testimony, which calculates a September 30, 2013 rate base amount for the Commission to consider, is equally specious. *See* NS-PGL Ex. 43.0 at 10. As noted in the AG Initial Brief, this so-called compromise introduces an entirely new set of rate base numbers not previously filed by the Utilities, including new Plant Additions, accumulated depreciation, deferred income taxes and all the other elements of the new, alternative rate base that should be rejected by the Commission. While rolling back the previously proposed December 31, 2013 forecasted numbers backward by three months, this proposal still fails to provide an equitable representation of the average plant investment (and other rate base element) values that better reflect the Company's actual capital costs in the test year and that match the rest of the determinants of calendar 2013 revenue requirements.

Finally, the Companies claim that "revenues and expenses generally are measured on a cumulative basis as of December 31st of the test year." NS/PGL BOE at 19. As support for this statement, they cite PGL Ex. 6.1, Sched. C-1 and PGL Ex. 5.1, Sched. C-4 and Mr. Kahle's statements on cross-examination. This exercise in semantics is faulty and potentially misleading. A review of the transcript shows that Mr. Kahle in no way was advocating expenses being reflected as year-end amounts in response to an engimatic, if not awkwardly worded question. Tr. at 157. That is especially true given Mr. Kahle's position that an average rate base should be used because it is consistent with the average income statement and cost of capital calculations that are employed for purposes of setting rates. *See* ICC Ex. 2.0 at 3. As for the referenced schedules, Schedule C-1 is captioned "Jurisdictional Operating Income Summary For the Test

Year Ending December 31, 2012" and Schedule C-4 contains "Comparative Operating Income Statements for Prior Years and the Test Year." While it is true that the revenue and expense amounts in these income statements are accumulated throughout an entire year, the amounts therein have not been annualized at year-end, as would be required to properly "match" a year-end rate base. The repeated assertion that there are cost "recovery shortfalls" (NS/PGL BOE at 19) are nothing more than the same hollow claims about missing cost recovery of forecasted gross plant amounts that have already been addressed above.

For all the reasons stated above, the arguments advocating the use of an average rate base or the Companies' alternative proposal should be rejected.

B. Retirement Benefits, Net

The People agree with the Proposed Order's clear and direct finding on the issue of Retirement Benefits, Net that: "…the Utilities' pension assets should not be included in rate base for the reasons stated in its past Orders." PO at 90. The Proposed Order tracks the proposed adjustment made by the People in the briefs in this docket. AG IB at 41. The adjustment presented by AG witness David Effron is consistent not only with past Commission practice, but it falls directly in line with the filed testimony of Staff witness Pearce and CUB/City witness Smith. AG IB at 41; *see* ICC Staff Ex. 14.0 at 3, ICC Staff Schedules 14.1N, 14.1P; CUB/City Ex. 1.0 at 18-22. The Commission has consistently found that accrued OPEB liability should be reflected in rate base but that pension balances should not be recognized in the determination of rate base. ICC Docket Nos. 11-0280/11-0281, Final Order (January 10, 2012) at 33. The People's adjustment follows these past Commission findings as it eliminates pension balances from rate base, treats the accrued liability for post-retirement benefits as rate base deductions,

and eliminates the accumulated deferred income taxes related to prepaid or accrued pensions. AG IB at 41.

The Utilities argue in their Brief on Exceptions that past Commission orders are not precedential and suggests that the record evidence in this docket is different from those prior dockets. NS/PGL BOE at 26, 28. The Utilities advance five theories upon which the Commission should consider re-evaluating its long-held stance on this issue. NS/PGL BOE at 27-28. In sum, the five theories attempt to demonstrate that ratepayers are somehow not ultimately funding the pension asset. As an example, the Utilities argue that the pension asset is owned by a trust and that customers are paying merely for the *accrual* of pension assets. *Id.* The Commission should not be swayed by these attempts. At the base of all of these technicalities stands a premise that stands in sharp contrast to a long-standing tenet of the Commission: shareholders may not earn a return on ratepayer supplied funds. ICC Docket Nos. 09-0166/09-0167, Final Order (January 21, 2010) at 36. Allowing any of the Utilities' recommended adjustments risks the backward and inequitable result of shareholders reaping a return on ratepayer-supplied funds. AG IB at 41. The Commission has long recognized the inequitable nature of the Utilities' desired result and the Proposed Order appropriately recognizes this. Therefore, the People urge the Commission to adopt the Proposed Order as originally written.

C. Accumulated Deferred Income Taxes – Appropriate Methodology To Reflect Change in State Income Tax Rate.

The Proposed Order got it right when it accepted the AG and CUB-City's position on the issue of ADIT – Appropriate Methodology to Reflect Change in State Income Tax Rate. PO at 112. As the Proposed Order correctly found, the AG/CUB-City position properly acknowledges the reality that future state income tax rates will be lower and this position accounts for the simple fact that ratepayers should not be forced to pay excessive deferred income tax expenses

today, unlike the Utilities' selection of the flawed Average Rate Assumption Method ("ARAM") approach that was used under difference circumstances back in the 1980's. PO at 112; AG Initial Brief at 47.

In the Utilities BOE, they persist in their argument that they are following a nearly 30-year-old directive on tax rate charges, as do all utilities, put into place in the 83-0309 Order. NS/PGL BOE at 33. Their continued reliance on the 83-0309 order, as well as the ARAM approach, is misguided and the Proposed Order properly makes note of this. The Utilities arguments express an on-going desire to take income tax deductions today that allow the deferral of taxes that would otherwise be payable at the current, higher rate of 9.5%, while ignoring the reality of lower future state income tax rates. AG IB at 47; AG Ex. 1.0 at 34. As demonstrated in the People's Initial Brief, the Utilities' desired deductions create a timing difference where the Companies are booking deferred income taxes at the higher rate, but when the time comes to pay the taxes, the taxes will actually be paid at the lower tax rates scheduled to then be effective. AG IB at 47. The Proposed Order correctly accounts for this inequity.

The Proposed Order acknowledges that the 83-0309 order held that the use of ARAM can be rebutted for good cause and goes on to find that the record evidence supports a finding of good cause for not employing ARAM in this matter. PO at 112. The Utilities argue in response that the AG and CUB-City did not demonstrate such good cause. See NS/PGL BOE at 32-37. As argued in greater detail below, the Utilities arguments fail. The People urge the Commission to adopt the finding of the Proposed Order as to the inapplicability of the 83-0309 order. As the People have previously argued, the 83-0309 docket was an investigation into ratemaking and accounting for excess deferred federal income taxes that required *reversals* of reduced tax rates more than twenty years ago. AG IB at 50. As with the Companies' proposed use of ARAM, this

is not at issue in this docket where the issue involves provisions of new deferred taxes (rather than reversals) and the Commission should view its prior order in 83-0309 as inapposite in the instant docket.

The Utilities arguments attempt to highlight intricacies in accounting for deferred income taxes and changes in income tax rates by discussing various differences in book and tax depreciation. NS/PGL BOE at 32-33. In the end, however, the Utilities' arguments tend to fall back to its original stance that the 83-0309 order is the way that it has been done by all utilities for 30 years. NS/PGL BOE at 33. Curiously, however, the Utilities argue that "all utilities" use ARAM and have for the last 30 years. NS/PGL BOE at 33. However, on the same page they are forced to acknowledge that both ComEd and Ameren, the two primary electric utilities in the State, have since adopted non-ARAM methods in their most recently decided rate cases, suggesting that ARAM is no longer as "in favor" as the Utilities suggest and defeating the arguments the Utilities present about consistency among the utilities state-wide. NS/PGL BOE at 37.

The Proposed Order appropriately found that

> "The lower deferred income tax balances and incremental higher rate base under the AG/CUB method (and that approved in the ComEd and Ameren dockets) represent an accounting for the simple fact that ratepayers are not being forced to pay excessive deferred income tax expenses today when the flawed ARAM approach is rejected."

Proposed Order at 112. The Utilities raise arguments that the Proposed Order's methodology distorts costs of service and are contrary to existing regulations on normalization. NS/PGL BOE at 34 - 36. The Commission should not be distracted by the Utilities' attempts to direct attention away from the heart of the issue: that ARAM is not applicable in this docket. As demonstrated in the People's Initial Brief, ARAM applies only to federal income taxes and not to the accounting for State income taxes. AG IB at 50. AG witness Mr. Brosch explained, in great

detail in his testimony, the applicable Internal Revenue Code section delineat the requirements for normalization, but these requirements have no applicability whatsoever to the Companies' rate case accounting for State income taxes. AG IB at 50; AG Ex. 1.0 at 39. Mr. Brosch further explained that part of the reasoning behind the implementation of ARAM accounting was to protect utilities from any rapid flow-back by regulators of the, as of the mid 1980's, excessive historically recorded federal ADIT balances, when Federal tax rates were reduced from 46 percent to 35 percent. *Id.* This is not the case in this docket nor does the record evidence support any conclusion that we are dealing with Federal income taxes or with the flow-back of historically recorded excessive ADIT balances. Rather, as demonstrated by the People's Initial Brief, the issue in this docket involves provisions of State ADIT. AG IB at 50-51. Therefore, the Proposed Order properly found in favor of the liability methods employed for deferred State income taxes, as used in the aforementioned ComEd and Ameren rate proceedings, and the People urge the Commission to consistently adopt the Proposed Order as originally written.

The Proposed Order properly recognized the known reality of the declining future income tax rates in Illinois, in order to properly recognize the deferred income tax liability in this docket. PO at 112. The People agree that the method adopted in the ComEd and Ameren dockets properly accounts for this situation and does not require ratepayers to pay excessive deferred income tax expenses as would the ARAM method favored by the Utilities. As demonstrated in the People's Initial Brief, despite the Companies' protestations to the contrary in their Brief on Exceptions, the accounting principles adopted in ComEd rate case and Ameren rate case apply in this docket. AG IB at 49-51. The 83-0309 Order is factually inapposite, given the temporary increase in Illinois income tax rates in the 2013 test year at issue in this docket. The Companies assert that the accounting procedures were employed in their last set of rate cases (Docket Nos.

11-0280/0281 cons.). While this is factually accurate, a review of the Commission's Order from 11-0280/11-0281 reveals that the alternative approach followed by ComEd and Ameren, and approved by the Commission, was not at issue. *See, generally,* ICC Docket Nos. 11-0280/11-0281 Final Order. Furthermore, the Order in the Companies' prior rate case does not list income tax expense among the contested issues and the only ADIT dispute involved accounting for uncertain tax positions using a 50/50 sharing.

As discussed in greater detail in the People's Initial Brief, the issue in the current docket has been resolved by the Commission in the ComEd and Ameren formula rate proceedings. AG IB at 49-51. The current docket has nothing to do with excess deferred income tax balances and has nothing to do with reversals of previously recorded ADIT balances. PGL and NSG are able, and should be required, to practice the same liability method of deferred income tax accounting that is employed by ComEd and Ameren for deferred tax provisions based upon the statutory state income tax rates that will be effective in future years when such provisions will reverse.[4]

Contrary to the Utilities Brief on Exceptions (NS/PGL BOE at 35), the People's proposed adjustment does not "flow through" a non-repeating benefit that will subsequently increase the carrying cost of that asset. AG IB at 52. The Proposed Order properly found that the AG and CUB adjustments were not "flow through" adjustments. The Commission should not be distracted from the actual issue before it, which is the appropriate State income tax rate to be used in recording deferred income taxes. If this were a "flow through" position, there would be no deferral of income taxes. As explained in greater detail in the People's briefs in this docket, the AG and CUB adjustment corrects test year deferred tax expense calculations to account for

[4] A liability method of accounting for Deferred Income Taxes is required under Accounting Standards Codification 840 ("ASC 840"). These requirements were previously referred to as Financial Accounting Standard 109 ("FAS 109") and require for financial reporting purposes that deferred taxes be provided in an amount sufficient to represent the estimated liability that will be paid when book/tax timing differences reverse in future period.

differences between current and future statutory tax rates, using the GAAP-required liability method of tax normalization accounting, with no flowing through of the tax deferrals arising from annual additions to utility plant. AG IB at 52. These leaves no uncertainty and, for ratemaking purposes, the deferred income tax expenses should be recorded at the income tax rates that will be effective when book/tax timing differences reverse in future years under the liability method. In consideration of the foregoing, the People urge the Commission to reject the Utilities' arguments and adopt the Proposed Order as originally written.

III. OPERATING INCOME

A. Adjustments to Integrys Business Support Costs

The Proposed Order correctly adopted the AG-proposed adjustments to several categories of IBS billings to Peoples Gas and North Shore where the projected expenses varied significantly from historical levels. PO at 160. While admitting that "the AG's proposed adjustments are more reasonable (than Staff's proposed adjustments)," the Companies nevertheless continue to challenge the adoption of these well-reasoned adjustments, which were made because the Companies simply failed to satisfy their burden under Section 9-201 of the Act to explain the variations.

First, it should be noted that the Companies' claim that "The depreciation cost issue appears to have been resolved" is incorrect. As support for this claim, the Companies cite to page 120 of the Proposed Order. That is not, in fact, correct. As noted in the AG's Initial and reply briefs, Mr. Brosch provided a revised adjustment for IBS depreciation expense at line 9 of AG Schedule C-8. In all, the AG's modified rebuttal position proposes to disallow: (1) "TEG Corporate Controller" expenses by $600,000 for Peoples Gas and $101,000 as to North Shore; (2) "IBS Legal – Centrally Budgeted" expenses of $591,000 for Peoples Gas and $61,000 as to

North Shore; and (3) *IBS depreciation costs* of $894,000 for PGL and $480,000 as to North Shore.

Mr. Brosch explained that IBS allocated charges to PGL and NSG include depreciation and amortization expense for assets employed by IBS to provide services to its affiliated companies. Mr. Brosch's analysis of IBS depreciation amounts forecasted for the 2013 test year indicated unreasonably large increases in projected amounts allocable to PGL and NSG. An adjustment was proposed in his Direct Testimony based upon the overall unexplained variance for such increased charges within the response to data request AG 3.14. Additional information provided by the Companies in response to AG data requests indicates the need for a more specific adjustment than for IBS depreciation, which is set forth in footnote (f) of Schedule C-8 of Mr. Brosch's Rebuttal Ex. 4.1(PGL) and 4.2 (NS). This more specific adjustment is to update depreciation charges for the updated in-service date expected to be achieved in June of 2013 for the GAP software development project to improve the Work Asset Management ("WAM") System, as more fully explained in the Companies' response to data request AG 12.20.[5] Additional follow-up discussion of the WAM GAP project was provided in the response to AG 13.10, which is included within AG Exhibit 4.9.

According to the response to AG 13.10(d)(xi), "The WAM GAP project will be in service in June, 2013. Updated depreciation numbers will be reflected in surrebuttal." The revised AG adjustment at line 9 of Schedule C-8 is needed to replace the full year of WAM GAP depreciation with a half-year of such depreciation based upon an assumed mid-year in service date for the project. AG Ex. 4.0 at 55-56.

Mr. Brosch originally included in his Direct exhibits an adjustment to update the IBS return on investment at AG Exhibits 1.3 and 1.4, Schedule C-9. The Companies' Rebuttal

[5] This response is included in NS-PGL Ex. 25.3, at Bates PGL 0018429 through PGL 0018582.

Testimony indicates that PGL and NSG do not contest making an adjustment to update the IBS return on investment charges that appear within the Utilities' operating expenses.[6] However, the Companies' adjustment for this purpose is tied to the level of return on investment most recently awarded by the Commission in Dockets 11-0280 and 11-0281, rather than the updated rates of return being proposed by the AG in Schedule D. In AG Exhibits 4.1 and 4.2, Mr. Brosch continued to update the IBS return on investment expense amounts as proposed in his Direct Testimony, but added a line 11 amount to account for the incremental adjustment now being made by the Companies, that revises the IBS return levels to the Companies' previously authorized overall return levels.

These adjustments, as provided in their final format and based on the evidence in the record, as listed in AG Ex. 4.1 and 4.2, Schedules C-8 and C-9, should be adopted by the Commission, as reflected in the Proposed Order and its Appendices.

As for the Companies' arguments against the Proposed Order's adopting of the AG's two IBS "home center" adjustments, these arguments are likewise specious. While the Companies claim they are "explained" the much higher projected expense levels, that simply is not the case. In fact, the evidence shows that the Companies' itemization of IBS Corporate Controller forecasted 2013 expenses includes more than $1 million for IFRS consulting work in 2013 that is highly speculative, and $140,000 for potential acquisition and merger-related services that are likewise speculative and, as such, should not be charged to the regulated utilities in Illinois if actually incurred by IBS. *See* AG Ex. 4.0 at 53; AG Ex. 4.7.

The Utilities further claim that the AG's proposed adjustments to the IBS Legal Home center costs also are without merit, arguing that "the 2010-2012 average was $7,421,000, and, with a 2.2% inflation rate (the Moody's inflation factor that was used by the Utilities when no

[6] NS-PGL Ex. 26.0, page 5, line 107.

other cost factor was known), that would result in a figure of $7,585,000, which is $48,000 more than the 2013 amount used by the Utilities." NS/PGL IB at 105-106. The record evidence, however, supports Mr. Brosch's proposed adjustment. The information provided by the Companies in response to data requests AG 12.19 and AG 13.16 supports a conclusion that legal fees in total have been overstated in the 2013 forecast prepared for the IBS Legal cost center. This overstatement can be observed in comparisons of forecasted 2013 amounts to recorded 2010, 2011 and year-to-date 2012 spending, as shown in Mr. Brosch's rebuttal testimony. AG Ex 4.0 at 54. The Companies objected to providing a more detailed breakdown of recorded historical legal fees, forecasting assumptions and calculations supportive of the test year IBS Legal forecasted amounts. Thus, there is insufficient information to justify forecasted IBS legal expenses and therefore such overstated cost amounts should be disallowed, as concluded in the Proposed Order. *See* AG Ex. 4.8.

As for the adjustment to IBS Corporate Controller allocated costs, the Companies simply reference "increased outside services related convergence standards and International Fincial Reporting Standards ("IFRS")" as the basis for the costs. NS/PGL BOE at 52. But here again, no further detail is referenced. As noted in AG witness Brosch's Rebuttal testimony, Corporate Controller IBS actual payments to vendors in 20122 totaled $3.3 million and in the 10 months ending October 31, 2012 totaled $2.6 million, but in the forecasted test year about $5.0 million of payments to vendors by IBS is forecated. This overstatement is simply unexplained by the Companies. *See* AG Ex. 4.0 at 53. Moreover, the additional IFRS costs and potential acquisition and merger-related services are speculative in nature, as detailed in NS/PGL data request responses that are attahced to Brosch's Rebuttal testimony as AG Ex. 4.7. This

adjustment, which is reflected in AG Ex. 4.1(PGL) and 4.2(NS), Schedule C-8, line 3, should be retained in the Commission's final order.

The Proposed Order agreed with those recommendations, and they should be adopted in the Commission's final order.

IV. RATE OF RETURN

A. Cost of Long Term Debt

The Utilities note in their Brief on Exceptions that "The AG argued that if the Utilities' rate base was set on a year-end basis, so should their long-term debt costs." NS/PGL BOE at 57. The People note that this is an over simplified characterization of the argument presented. However, as the People explained in the Initial Brief, this issue only merits attention if the Commission approves the Utilities desired year-end rate base. AG IB at 98. The Proposed Order adopted an average rate-base, therefore this argument is rendered moot. PO at 38. However, in the event that the Commission adopts a year-end rate base in the final order, the People would re-assert the argument as originally detailed in the People's Briefs in this docket. AG IB at 98. The essence of that argument is the recommendation for utilizing a year-end costing approach to quantify the cost of long-term debt in order to achieve fairness and consistency. The Companies should not be allowed to quantify rate base at year-end to increase revenue requirements, while ignoring the declining costs of long term debt that would be lower if consistently annualized at year-end. Any other result would deny ratepayers full participation in the annual interest savings resulting from such refinancing.

V. RATE DESIGN

A. Service Classification No. 1, Small Residential Heating Service

The Companies take issue with the Proposed Order's adoption of Staff's Small Residential Heating proposed rates, which increases the recovery of non-storage related utility costs from 67% to 68% through the customer charges for North Shore (a conclusion to which the People do not object) and from 54% to 61% for Peoples Gas (a conclusion the People opposed, as noted in the AG Brief on Exceptions). PO at 237. The Proposed Order makes clear that this increase in the customer charge to recover more of the Companies costs through the monthly flat charges is tied to the continued belief, despite evidence to the contrary, that all of the Cmopanies' costs are fixed. *Id.*

The People characterize this continued march as inexplicable in our Brief on Exceptions because, quite simply, the substantial evidence in the record shows that demand-related costs account for 38% of Peoples' and 32% of North Shore's total cost of serving residential heating customers ($147.9 million out of $387.8 million for PGL, $20.7 million out of $65.7 million for NS). NS-PGL Ex. 33.14, p. 1 (PGL); NS-PGL Ex. 33.7 p. 1 (NS). Likewise, there have been radical increases in the customer charge portion of PGL and NS residential customer bills since 2007 – and the notion that this march toward greater cost recovery in the customer charge must continue indefinitely – are not supported by the Companies' cost studies or rate design principles of cost causation, equity and fairness. *See* AG Initial Brief at 102; AG Cross Ex. 25.

AG Cross Ex. 25 showed that since 2007, the Peoples Gas customer charge for residential customers has increased 147%. The PGL proposal to recover 80% of their non-storage related costs through the customer charge would increase that percentage to 318% since 2007. AG

Cross Ex. 25. Similary, for North Shore, AG Cross Ex. 24 showed that since 2007, the Peoples Gas customer charge for residential customers has increased 159%. North Shore's proposal to recover 80% of their non-storage related costs through the customer charge would increase that percentage to 248% since 2007. AG Cross Ex. 24.

The question that must be asked, is when does this unnecessary march toward higher and higher fixed charges in residential customers' gas bills end? Unfortunately, these facts are never addressed by the Companies in their Brief on Exceptions or the in Proposed Order. Instead, the Companies continue to complain, despite the generous increase in fixed charges enabled by the Proposed Order and the continuation of Rider VBA, which ensures that the Companies' receive the residential and small commercial customer classes' portion of the revenue rqeuirement established in this case.

For example, referencing the Proposed Order's interest in observing the effect of bifurcation of the residential customer classes before moving toward even more cost recovery in fixed monthly charges, the Companies' opine "it is unstated what the Commission or Staff expects to obesrve about bifurcation's effectg on S.C. No. 1 heating customers by limiting the increase in fixed cost recovery through fixed charges or why any observation about bifurcation would affect the fundamental principle that fixed costs should be recovered through fixed charges." NS/PGL BOE at 70. They further remark that the Proposed Order does not explain how Staff's proposal, more than the Utilities' proposal, advances the three cited rate design principles: gradualism, rate continuity and rate understandability. *Id.*

A couple of responses are in order to these criticisms. First, the notion of treading carefully when increasing residential customer charges (and in the Proposed Order's language, waiting to observe the impact of new rate designs) is an admirable objective. The Companies'

desire to increase the customer charge for residential heating customers to recover 80% of their costs through the fixed monthly charges is a radical change that simply is not justified by the record evidence. As noted in the People's Brief on Exceptions, the substantial evidence in the record shows that demand-related costs account for 38% of Peoples' and 32% of North Shore's total cost of serving residential heating customers ($147.9 million out of $387.8 million for PGL, $20.7 million out of $65.7 million for NS). NS-PGL Ex. 33.14, p. 1 (PGL); NS-PGL Ex. 33.7 p. 1 (NS). *See* AG BOE at 39-40. Demand-related costs are *by definition* driven by customer usage. Thus, the notion that the Companies' costs are entirely fixed is simply a myth.

Second, the People agree that the traditional rate design principles of gradualism, rate continuity and rate understability should guide the Commission's thinking as it establishes rates in this case. That being said, it is AG witness Scott Rubin's rate design that best follows those important guidelines. As noted in the AG Brief on Exceptions, Mr. Rubin's recommended customer charge levels recover less demand-related costs than the 80% level proposed by the Companies or the 68% and 61% levels proposed by Staff witness Johnson for North Shore and PGL, respectively. **Under Mr. Rubin's proposal, PGL would recover 55% of residential heating costs (as compared to its current 54% level) and North Shore would recover 60% of heating costs (as compared to its current 67% level) through the customer charge. *See* AG Ex. 6.03 (PGL) and 6.04 (NS), page 3**[7]. That level of cost recovery through fixed charges translates into a slight increase for Peoples Gas and a small decrease for North Shore. The AG rate design, thus, adheres to the principles of gradualism , rate continuity and understandability

[7] These percentages are calculated by taking the customer charge revenues in the last column divided by total revenues. It doesn't matter (for this calculation) whether you use the companies' revenue requirement column or the AG revenue requirement column - the percentages are the same.

that should guide the Commission, and does so to a greater extent than either the approved Staff or 80% NS/PGL rate designs.

The Companies' final argument, wherein it states that the Utilities' proposal "more clearly shows the Commission the amount of fixed cost recovery through fixed charges and offers more certainty for fixed cost recovery" is a strawman argument. NS/PGL BOE at 71. In fact, all of the specific rate design proposals will ultimately be adjusted based upon the final revenue requirement established in the Commission's final order. What the Commission does know at this juncture that the Companies' 80% rate design would radically increase customer charges, and diminish customers' abilities to control their monthly bills through conservation and efficiency investments by placing more cost recovery in the fixed customer charge. That continued march toward removing customer control of bills is bad public policy, and inconsistent with Section 8-104 of the Act, which declares that cost-effective energy efficiency be used to reduce direct and indirect costs to consumers. 220 ILCS 5/8-104. Certainly, a rate design that continually removes customers' ability or incentive to invest in efficiency by making a greater percentage of their bill fixed is contrary to that stated legislative goal.

For all of these reasons, the Companies' arguments in support of a rate design that recovers 80% of its costs through fixed customer charges should be rejected. Instead, as noted in the AG Brief on Exceptions, the Commission should adopt AG witness Rubin's proposed residential heating rate design.

B. Service Classification Nos. 1 and 2, Alternative Conditional Straight Fixed Variable Rate Design

At page 72 of the Brief on Exceptions, the Companies argue that because the People are filing a Petition for Leave to Appeal with the Supreme Court related to the Second District

Appellate Court's decision affirming the Commission's 2012 approval of a permanent Rider VBA mechanism[8], there still is just cause to approve the Companies' Alternative Straight Fixed Variable Rate Design, which is a conditional tariff that would *possibly* take effect at some unknown date in time, depending on events outside of the Utilities and the Commission's control, is unlawful on its face. The People have fully explained in Initial and Reply briefs, as well as their Brief on Exceptions, why approval of this unorthodox tariff is unlawful. Those arguments will not be repeated here. *See* AG Initial Brief at 120-124; AG Reply Brief at 63-65 ; AG BOE at 48-50.

The Commission should reject the Companies' invitation to commit reversible error, and reject the tariff. The Proposed Order should be modified in accordance with the language supplied in the Peoples' BOE at pages 50-51 to fully address the Companies' assertion that such a tariff is needed or appropriate should Rider VBA some day be declared unlawful.

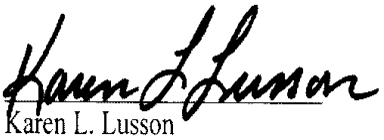
VI. CONCLUSION

For all of the reasons stated above, the People of the State of Illinois urge the Commission to adopt a Final Order consistent with the recommendations in this Brief and the AG Brief on Exceptions.

Respectfully submitted,

The People of the State of Illinois
by LISA MADIGAN, Attorney General

[8] *See Madigan v. Illinois Commerce Comm'n,* 2013 IL App (2d) 120243 ¶¶ 10, 28 ("*Madigan II*").



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